

Linked Financial Products

- 1) **Mezzanine Finance;** is most often used to finance the expansion of existing companies or the buyout of another company. It is typically a mixture of Debt and Equity. The lender will receive Interest in return for Capital and a stake in the Equity of the Company; either in the form of Warrants or a Debt Conversion vehicle like a Convertible Bond. If the borrower fails to repay the Lender has the relative security of being able to convert the Debt into Equity.

Rates of interest are higher with Mezzanine Finance which is a reflection that funding can be acquired more quickly without the usual due diligence or collateral requirements. As this is a high risk product it is unlikely that new companies without a track record or reputation in the industry; a history of profitability or reliable business plan, will be able to access it.
- 2) **Sale & Lease Back;** this is a method for Asset rich companies with cash flow problems to inject cash into the business. Effectively they sell the assets to a Finance Company and lease them back. The assets; typically Plant, Machinery & Vehicles become periodic expenses of operating profits.
- 3) **Secured Lending;** Lending secured on the assets or property of the business with a second (or subsequent) legal charge. The Interest rate offered will be reflected in the risk profile of the client.
- 4) **Asset Finance;** There are several types of Asset Finance:
 - a) **Leasing/Lease Purchase;** The Finance Company owns the Asset and rents it to the Business. The Business takes possession of the Asset and uses it however; it does not actually own it during the term of the Lease. Depending on the Lease Agreement the Business may have the Option to buy the Asset at the end of the Lease or sell it to another party.
 - b) **Hire Purchase;** The Business rents the Asset from the Finance Company and has the Option to purchase it. The Business pays a primary deposit at the start of the agreement followed by monthly instalments over an agreed term. At the end of the term the Business can take outright ownership for a nominal sum. Typically the length of lease will be less than the working life of the Asset.
 - c) **Contract purchase;** Similar to lease purchase however, the Business is committed to buying the Asset at the end of the contract.
 - d) **Contract Hire;** Similar to Contract purchase but the Business does not take ownership at the end of the contract. Typically, the contract will include maintenance, repairs or replacement.
 - e) **Finance lease;** The Business (lessee) leases the Asset from the Finance Company, the monthly lease cost is calculated to cover the full cost of the Asset and Finance Charges by the end of the term of the Lease. The lessee is responsible for all maintenance, repair or replacement during the term but does not acquire ownership at any point. At the end of the lease there are usually three options:
 - i) The lease is extended at a lower rate
 - ii) The lease is terminated; the lessee may receive some of the proceeds of sale
 - iii) The Asset is replaced and a new lease established
 - f) **Operating Lease;** This is typically a shorter lease length (less than the working life of the Asset). At the end of the lease the Asset is either sold or re-leased. The Lessee does not receive any of the sale proceeds if sold and will not take ownership at any time.

- g) **Factoring;** In response to the difficulties that Trading Companies sometime have with Cash Flow it is possible for them to factor (share) their Debtors. Debtor balances are Assets of the Company. Cash tied up in Debtor balances can restrict a Businesses ability to invest; if they have to use an Overdraft facility the costs of lending can prohibit growth. A Factoring Company can take title to the Invoices in exchange for a cash advance to the Company. The Factor then owns the debt and will collect it directly from the Company. Any balance due to the Trading Company will be paid less any fees due.

The costs of Factoring are significant; typically an interest rate 1.5% to 3% above base rate, ledger administration 0.75-2% of turnover depending on volume, money transmission fees and the possibility of arrangement fees.

Advantages

- Cash Flow benefits
- Reduction in administration costs as Debt chasing is now done by 'the factor'.
- An Overdraft limit is no longer a confining limit.
- The overall costs may be lower than Overdraft.

Disadvantages

- The charges will reduce the monies received.
- If the factor cannot collect it may be able to claim the balance back from the Business.
- The Business loses its personal link with the client.
- Future ability to borrow may be reduced as the security of Book debts is no longer available.

There are also risks to the Factor; their arrangement may not allow them to seek redress from the client in case of non collection of debt and/or the Client may not be able to pay in the event of such a claim.

- h) **Invoice Discounting;** Similar to factoring however there are marked differences:
- i) The ownership and administration of the Debt remains with the Business therefore, administration costs are not reduced.
 - ii) When the business has received payment it repays the factor the advance less their charges.